

April 28, 2020

Remi Sun
Chief Financial Officer
PO Box 600
Scobey, MT 59623-0600

Re: Response to Comments on the 2020 Capitalization Rate Study, Telecommunications

Dear Ms. Sun:

The department would like to thank you for taking the time to review our study and for providing comments for our consideration. The following information was provided: your submission email received April 8, 2000, which included a letter that detailed what areas of our study should get further consideration.

Below is a brief summary of the issues raised:

Concern was raised of the capital structure selected in our study and how it has continued to diverge from the book capital structure of Nemont's companies. It was also stated that due to lack of publicly traded companies that operate in Montana, the guideline companies used in the study are not representative of the rural telecommunications companies.

It was requested we utilize the information submitted by rural telecommunications companies when considering the capital structure.

Although we are aware of the increased challenges posed in providing telecommunications services to rural communities; after reviewing the letter and performing some additional analysis it was determined that at this time no adjustment is warranted to the capital structure nor the guideline companies. Currently, no better information or guideline companies are available to develop a cost of capital and the financials of rural telecommunications companies (more accurately described as telecommunications cooperative information) pose considerable challenges to their use which is discussed in detail below.

Book vs Market Capital Structure

A key factor in developing a discount rate is to consider the source, cost, and availability of capital. The discount rate is equal to the "cost of capital" which is the expected rate of return that the market requires in order to attract funds to a particular investment. Two of the most commonly used sources of capital are debt and equity. When determining a discount rate the cost of equity, cost of debt, and their individual contributions to the total must be considered.

It is inappropriate to use a book value capital structure when determining the appropriate % of debt and equity for a discount rate. When determining the capital structure (% debt vs % equity) it is imperative that the capital structure be based on the market weightings. It is based on what investors require to invest in similar property with comparable risk. The key here is that both the required returns as well as the capital structure are market based.

Although some rural communities receive telecommunications services from subsidiaries of cooperatives, none of which are publicly traded, several of the guideline companies used in our study do in fact provide rural telecommunications services and some provide such services in Montana.

Telephone Cooperatives

The difficulty posed by providing telecommunications to rural markets is one of the reasons that many rural communities have these services provided by a cooperative.

A cooperative can be defined as a business owned and democratically controlled by the people who use its services and whose benefits are derived and distributed equitably on the basis of use.¹

Members unite in a cooperative to get services otherwise not available, to get quality supplies at the right time, to have access to markets or for other mutually beneficial reasons. Acting together gives members the advantages of economies of size and bargaining power. They benefit from having these services available, in proportion to the use they make of them.

Members also benefit by sharing the earnings on business conducted on a cooperative basis. When cooperatives generate margins from efficient operations and add value to products, these earnings are returned to members in proportion to their use of the cooperative. Without the cooperative, these funds would go to other middle men or processors.²

The people who use a cooperative own it. As they own the assets, the members have the obligation to provide financing in accordance with use to keep the cooperative in business and permit it to grow. Accumulating adequate equity is a major challenge facing many cooperatives.³

The last sentence in the prior paragraph highlights the difficulty in using cooperatives to develop a discount rate and/or a capital structure. Members form a cooperative to get a service—source of supplies, market for products or performance of specialized functions—not a monetary return on capital investment.⁴

Equity in a cooperative is wholly different than equity in an investment asset. In fact, this structure exists to discourage an investor from acquiring the property as limiting returns on equity supports the principle of distributing benefits proportional to use. It also discourages outsiders from trying to wrest control of a cooperative from its members and operate it as a profit-generating concern for the benefit of stockholders.⁵

People buy stock in a non-cooperative business to make money on their investment. The more of the company you own, the more benefits (stock appreciation and dividends) you will realize if the business succeeds. The benefits of being a cooperative member differ in two ways. First, the advantages are more numerous. Second, they are distributed on the basis of how much use you make of the cooperative, rather than your equity stake.⁶

These principles hopefully help shed some light on our difficulty with using cooperatives as guideline companies.

Ultimately the additional challenges posed to rural telecommunications should show up in decreased earnings and should not be addressed through changes to the cost of capital, as the cost of capital is established by investors and what return they require to invest.

¹ USDA Cooperative Information Report 55, Co-ops 101: An Introduction to Cooperatives, Pg. 1

² Ibid, Pg. 9

³ Ibid, Pg. 10

⁴ Ibid, Pg. 13

⁵ Ibid, Pg. 13

⁶ Ibid, Pg. 25

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Again, I would like to thank you for your comments and the additional information you provided for our consideration. I look forward to any further discussion we may have throughout the 2020 appraisal season.

Our final 2020 Capitalization Rate Study for Telecommunications can be found at:

<https://mtrevenue.gov/publications/cap-rate-studies/>

Sincerely,

A handwritten signature in black ink that reads "Doug Roehm". The signature is fluid and cursive, with a long horizontal stroke extending from the end of the name.

Doug Roehm, Unit Manager
Centrally Assessed & Industrial Properties
Montana Department of Revenue
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